2009

# The Economic Impact of Venture Capital and Private Equity in South Africa

SAVCA

SAVCA - Southern African Venture Capital and Private Equity Association

DBSA

Development Bank of Southern Africa

# Foreword

Over the last decade, the South African private equity industry has grown significantly, with over R100bn under management in 2009. The industry occupies a specialised niche with a significant role in the overall South African economy. Although private equity is best known for maximising investor's returns, it has an important role in development. As a long-term provider of risk capital, it contributes to economic development by building sustainable businesses, increasing private sector participation in the economy, attracting private capital to the region and adopting world-class levels of corporate governance. DBSA has long recognised that there is significant impact by private equity firms in improving lives and livelihoods through increasing GDP, employment and developing capital markets both in South Africa and across the continent.

In the past, there has been limited quantifiable, standardised information on measuring the impact of private equity on the economy as a whole. This first ever economic impact survey has been important to develop a snapshot view of the impact of private equity portfolio companies and private equity fund managers on the South African economy. SAVCA intends to use this, over time, as a basis to develop trends data on the impact of private equity portfolio companies and private equity fund managers on the South African economy as well as pre- and post- private equity investment data.

The highlights of the report show that over the three-year period from 2005/6 to 2008/9, private equity-backed companies have achieved growth rates in employment, turnover and profit that are above the average of comparable listed firms and importantly, the report confirms the dramatic up-tick of elements within the BEE scorecard post the investment by private equity funds.

The impact of private equity is wide on the South African economy and contributes to key growth targets of the Government – in employment, export and improved competitiveness of South African firms. Special thanks are extended to the SAVCA members and their portfolio companies that participated in the survey and made this first report possible.

We are pleased to record the contribution private equity is making to South Africa's growth and look forward to this survey occurring regularly.

Emile du Toit

*Divisional Executive:*
Private Equity and Investment Banking
Development Bank of Southern Africa

# About the survey

This is the first edition of the Development Bank of Southern Africa's (DBSA) and Southern African Venture Capital and Private Equity Association's (SAVCA) study of the economic impact of venture capital and private equity within South Africa.

While a range of research into the venture capital and private equity industry exists, the opinions of the businesses that have been the recipients of private equity investment has not been gathered before.

The perceptions of portfolio business managers on the impact of private equity on their businesses, are an extremely important factor in any attempt to measure the broader economic and social impact the industry has on the nation as a whole.

327 businesses that have received private equity backing responded to the survey[1], and overall, the findings indicate a significant and positive impact.

## Some highlights

**Over the three-year period from 2005/6 to 2008/9, private equity backed companies in South Africa have achieved:**

- Annual world-wide employment growth rates of 9%, compared with JSE listed business's growth rates of 4% and 8% recorded for private equity backed businesses in the UK[2&3].
- Employment of 5% of South African formal sector employees which equates to around 427 000 jobs.
- Average domestic employment growth rates of 10% per annum, compared with 1% across all businesses in South Africa and 4% for UK private equity backed businesses.
- Average turnover growth of 20%, compared to 18% for JSE businesses and 8% for UK private equity backed businesses.
- Pre-tax profit growth of 16% per annum compared to 14% for JSE businesses and 11% for UK private equity backed businesses.
- Growth in exports of 31% per annum, on average, compared with 24% nationally and 10% for UK private equity backed businesses.
- Average R&D expenditure growth of 7% compared to 1% for JSE listed businesses.



[1] A detailed explanation of data collection can be found at the back of this report.
[2] UK figures from the BVCA's Economic Impact of Private Equity and Venture Capital in the UK, 2008.
[3] Note that for this study, growth rates are average annual rates for a five year period.

## Private equity backed businesses in numbers

- **82%:** the proportion of respondents growing chiefly by organic means since private equity investment; similar to the 84% recorded for UK private equity backed businesses.
- **64%:** the proportion of respondents that said they would have developed less rapidly without private equity investment.
- **47%:** the proportion of respondents that said they would have not existed or survived without private equity investment.
- **54%:** the proportion of respondents that said the introduction of BEE was only made possible through private equity investment.
- Post the private equity investment, the number of black-empowered enterprises nearly tripled.


### *Note*

*This report is an honest attempt to quantify, for the first time, the economic and social impact that private equity backed businesses are making in South Africa; that impact is vast, as we have shown, but it is also breakable. If the industry is to continue to thrive and deliver these benefits to the businesses and people of South Africa, it is crucial that it is supported by Government and institutional investors.*

# Putting private equity into context

The success of private equity as an asset class in the late 1990s, particularly in the US, led to the acceleration of the development of a professio-nal private equity management industry in South Africa. Funds were sourced from third party investors such as pension funds and insurance companies. By the year 2000, 40% of funds under management were owned by independent funds.

2001 saw a peak in new investments made with 534 deals completed. The dot.com crash the following year negatively impacted the market with a 17% drop in new investments.

The market has since recovered and 2007 saw new records in both volume and value, with 599 new investments made at a value of R24.7bn, the latter representing a 357% growth on the previous year's figures.

The global economic crisis has reversed this growth, although the R12.8bn new investments made in 2008 exceed the investment value of any year prior to 2007.

## South African private equity activity


Source: KPMG/SAVCA

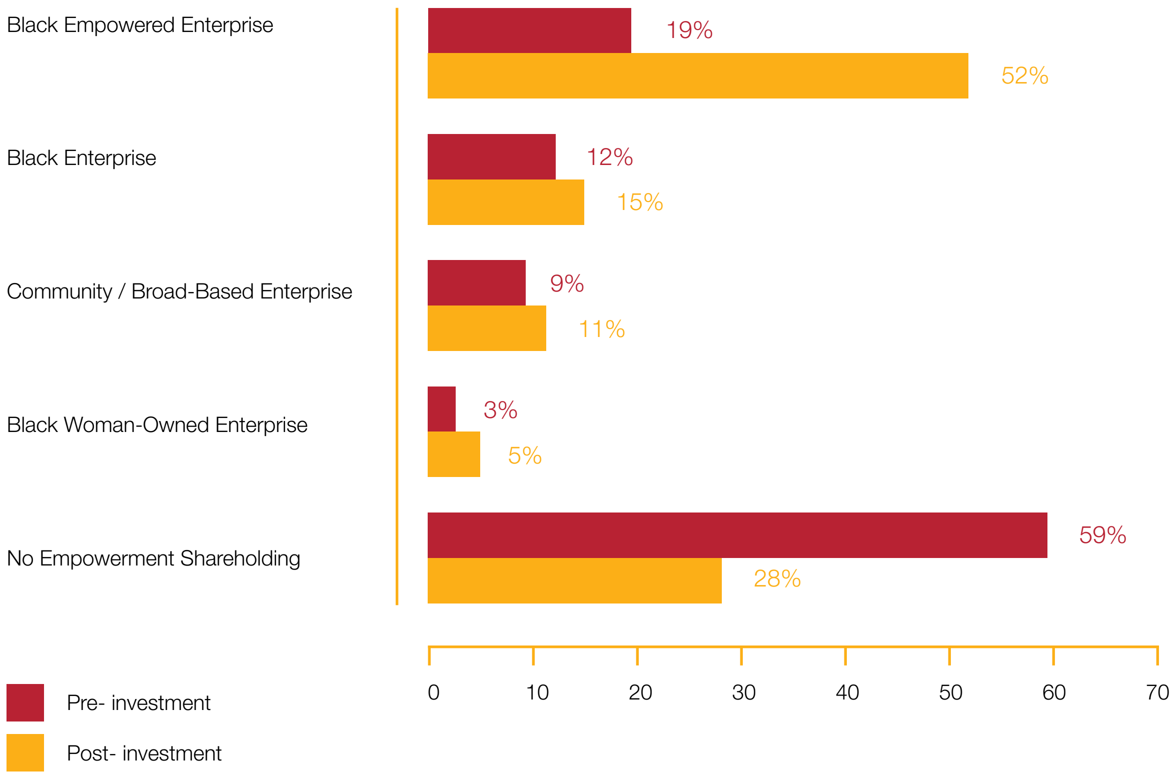

860
840

# The impact of private equity on BEE

The social impact of private equity investment can be seen most clearly in the dramatic up-take of elements within the BEE scorecard. In fact, 54% of portfolio companies responded that the introduction of BEE was only made possible through private equity investment. Post-investment, the number of black-empowered enterprises nearly tripled and there were more black woman-owned enterprises, too.

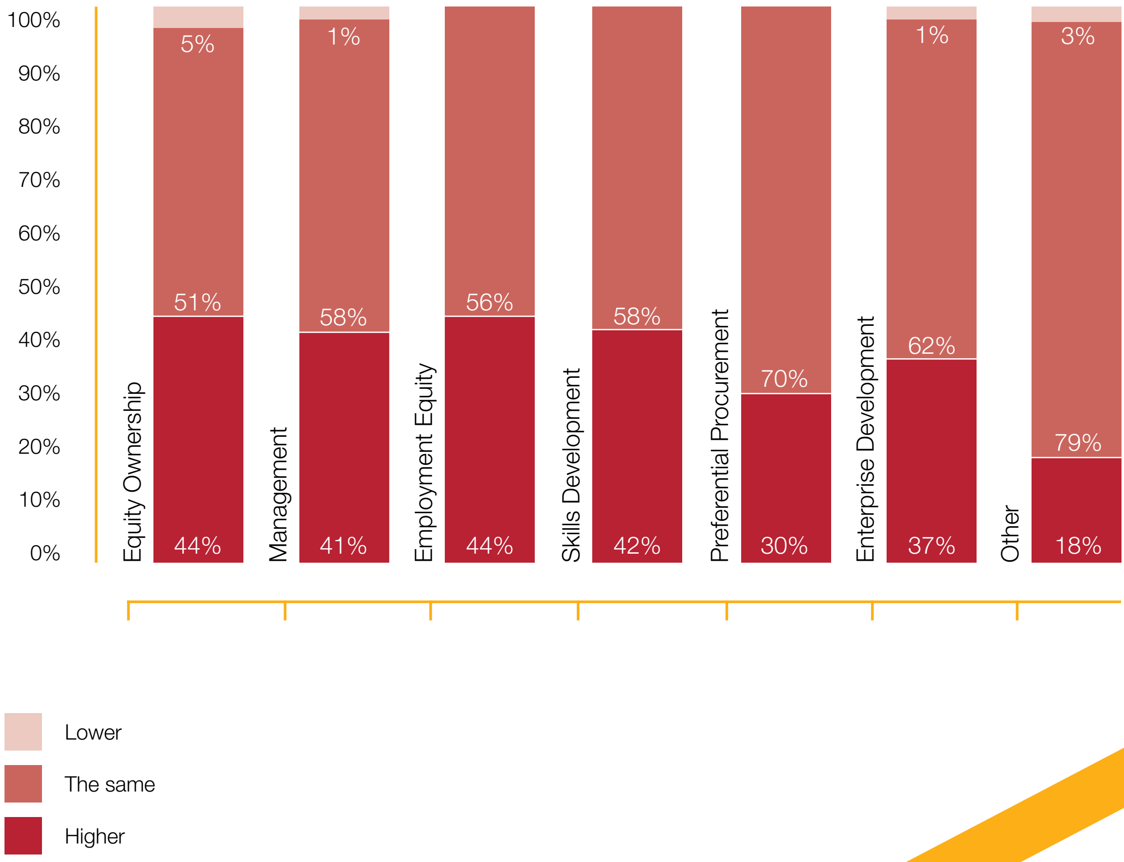
Prior to investment, 59% of respondents had no empowerment shareholding at all. After investment, 72% were black-owned, black-empowered or were community or broad-based enterprises. This represents an increase of 31 percentage points.

## BEE classification pre- and post-investment




Since investment, at least 40% of respondents report seeing an improvement in performance across all elements of the BEE scorecard.

## BEE scorecard performance since investment




# Investee growth

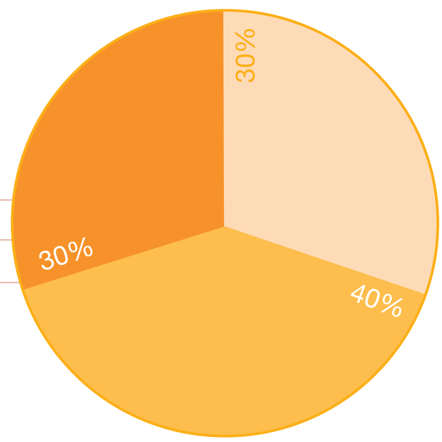
Survey respondents represented the full spectrum of businesses ranging from recently foun-ded within the last five years (26%) to being in business for more than 30 years (17%).

Respondents included 22 businesses with sales of under R5m and a similar number with sales of at least R2bn[4]. Eight businesses at the lower end of the sales spectrum reported their latest sales figures to be under R1m (these were, in the main, early-stage recipients of minority investments).

The type of investment initially received by respondents was evenly spread across seed and early stage capital and buyouts (30% each). Expansion and development capital was the most popular type of investment (40%).

## Type of investment initially received

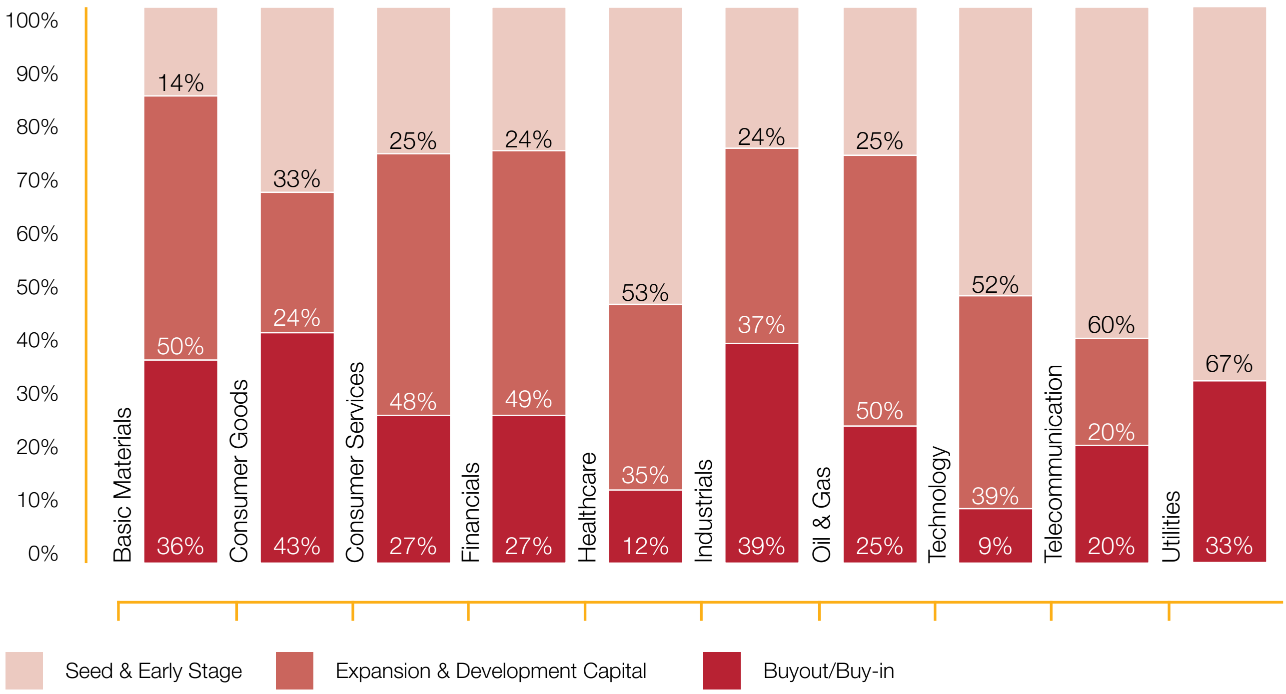
| | |
|---|---|
| Seed & Early Stage | 30% |
| Buyout/Buy-in | 30% |
| Expansion & Development Capital | 40% |




The type of investment tended to vary by sector, with healthcare and technology receiving more seed and early stage capital than others.

[4] Please note that turnover information was not provided by all respondents.

## Initial investment by sector




# Growth paths

Organic growth was predominant for most respondents before and after receiving private equity backing. Post-investment figures do show slightly more respondents (18%, up from 16%) growing via acquisition than before investment.

> As one might expect, seed and early stage backed firms did not exhibit any greater propensity, post-investment, to pursue an acquisitive growth strategy, with 88% (the same proportion as pre-investment) growing organically. Nearly a quarter of buyout portfolio companies (22%, up from 18%, before investment) report growing primarily through acquisition post-investment.

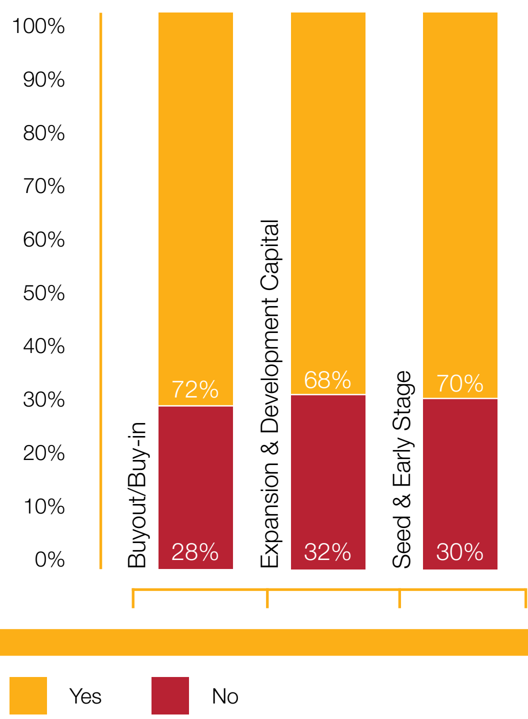
# Innovation

69% of private equity backed businesses have introduced new products and/or services in the last two years.

Somewhat surprisingly, is the fact that buyout firms were slightly more innovative than early stage firms in terms of bringing new products and services to market.

Not surprising however, is the fact that utilities and the oil and gas sectors were least innovative; with at least 50% of each of these sectors not having introduced new products. Technology and telecommunications firms were at the other end of the spectrum with approximately 80% having brought new products to market in the last two years.

## Innovation by finance stage

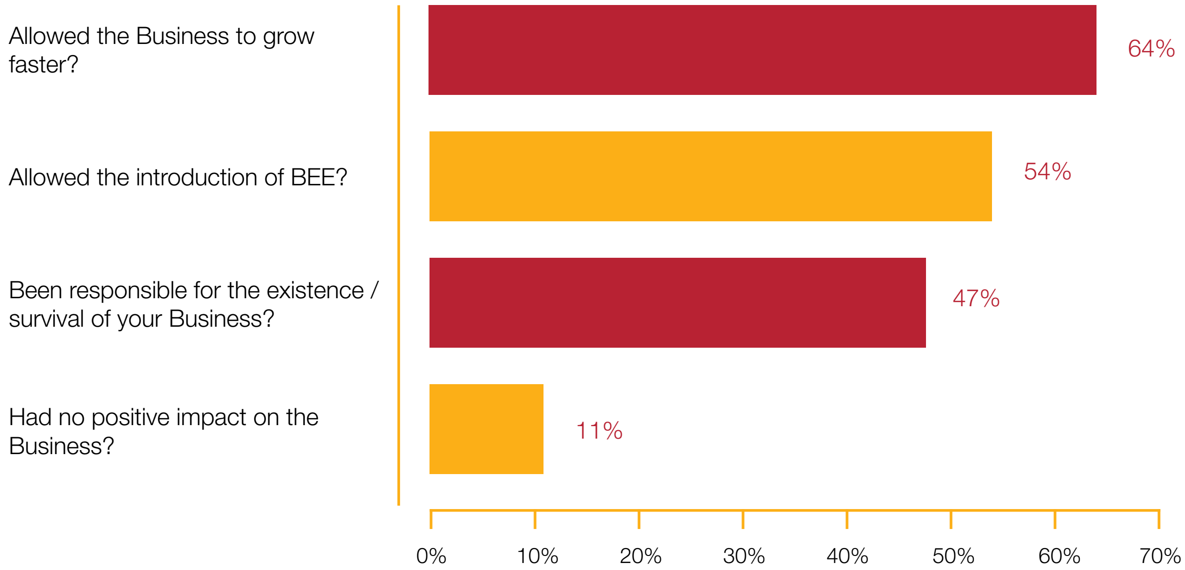


# The role of private equity

## Contribution

In the main, respondents report that private equity has made a positive contribution to their business. 64% felt the investment(s) allowed their business to grow faster. 54% stated that private equity allowed for the introduction of BEE and 47% felt they would not have existed or survived without private equity financing. Only 11% reported that there was no positive impact on their business from the investment.

### Private equity contribution

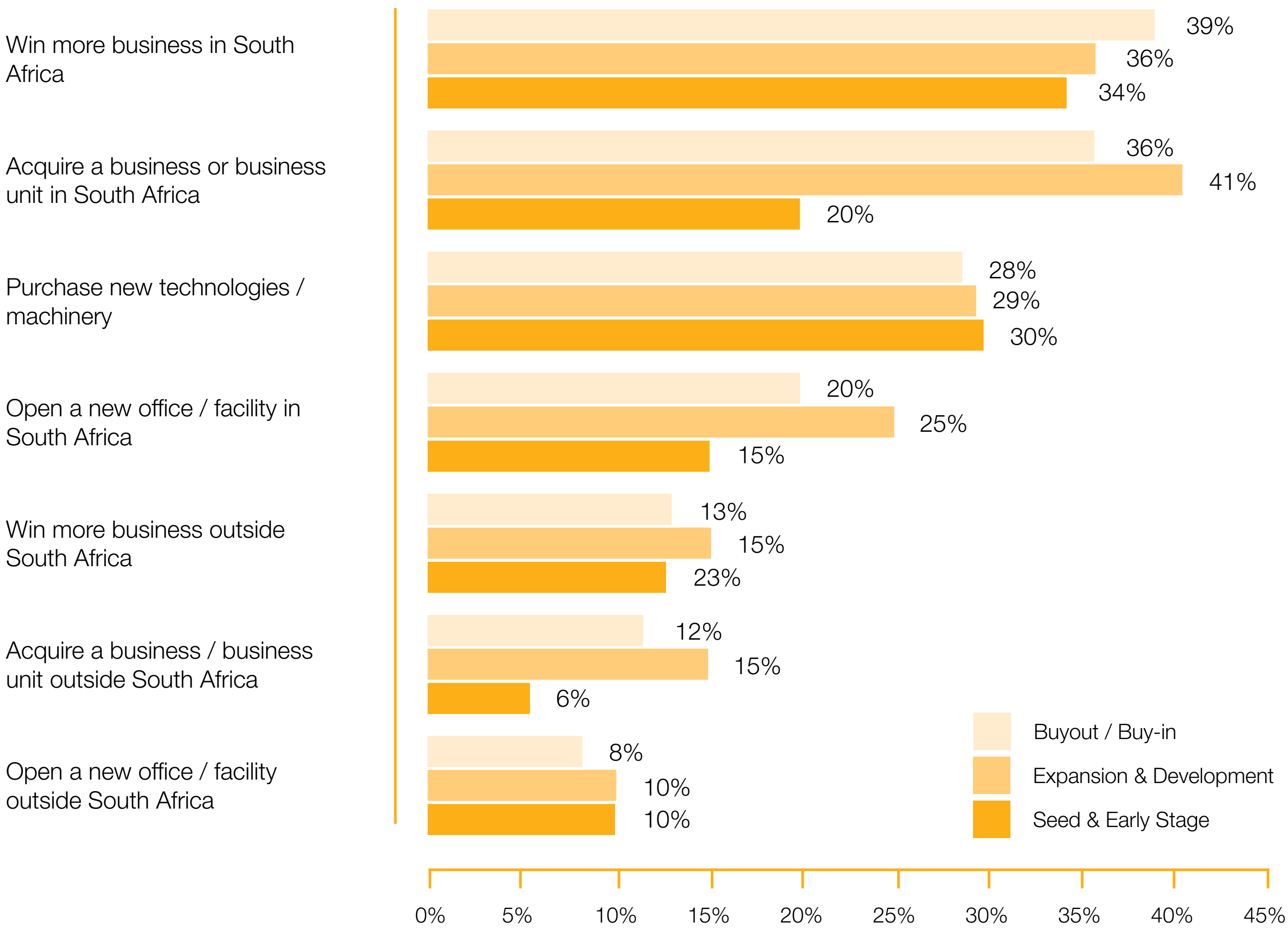



## Achievement

36% of investees are winning more business and 33% are able to acquire a new business or business unit because of the private equity investment. Generally, private equity has aided investee businesses to achieve more than was possible without that investment. However, just less than a quarter of respondents (22%) reported no additional business achievements post-investment.

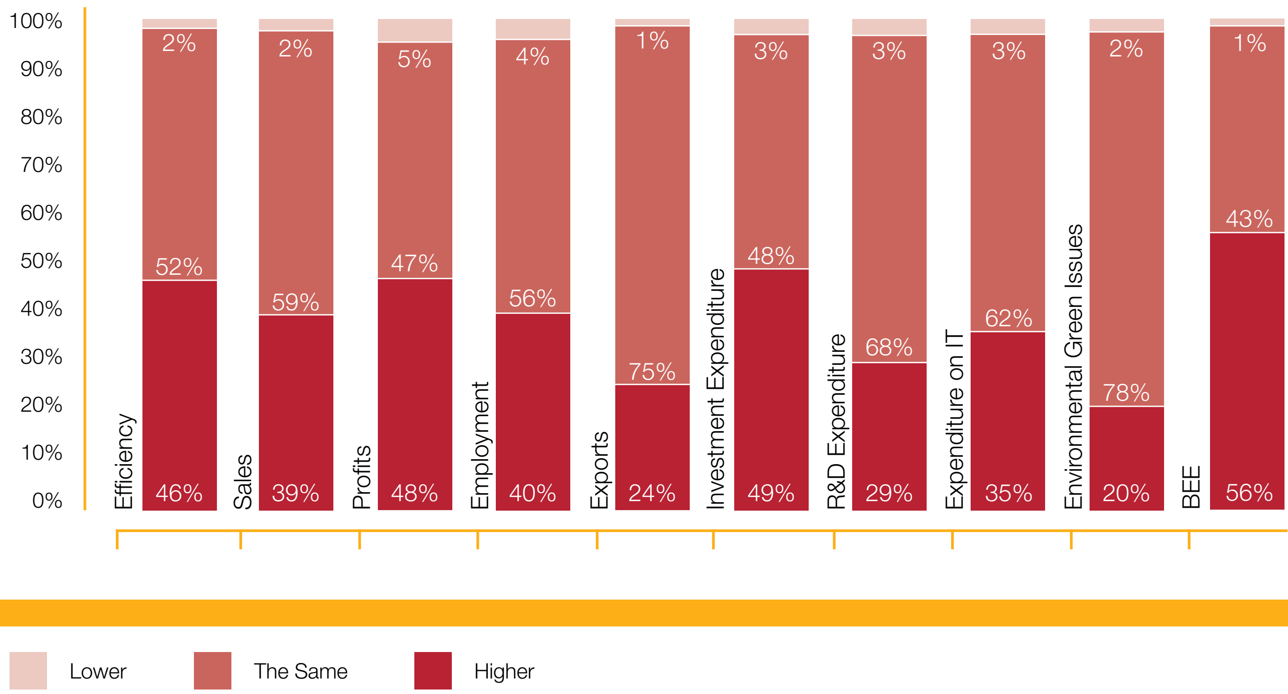
> On analysing investee businesses by finance stage, it is clear that the financial boost provided by private equity backing goes a long way to assisting investees to reach key achievements.

## Business achievement by financing stage




## Impact

Respondents report that performance in key areas of business had improved since receiving private equity backing. Over half of respondents (56%) indicated that BEE performance has been higher post investment. Investment expenditure and profits are also cited as having increased by a substantial proportion (49% and 48% respectively). A negligible number of respondents feel that their performance has worsened across key performance areas.



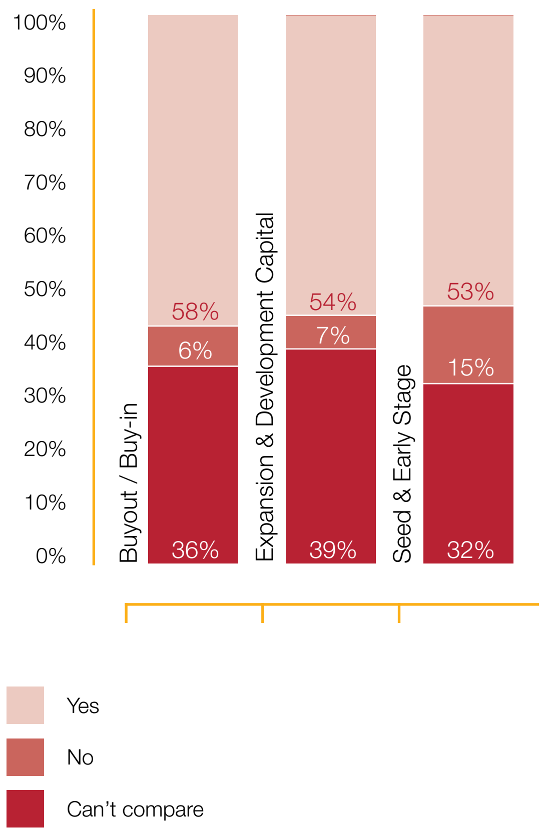
# The role of private equity (cont.)

## A preference for private equity

Respondents were asked if they felt private equity was preferable to other forms of financing. For the more mature businesses, public equity is the obvious point of comparison whilst at the seed and early stage, bank financing is an alternative. 36% of respondents felt unable to make a comparison, but of those that did, the overwhelming majority (86% of those who answered "yes" or "no") felt private equity was preferable to other forms of equity financing.

When analysing preference by financing stage, responses were fairly similar.

### Preference for private equity financing – by financing stage

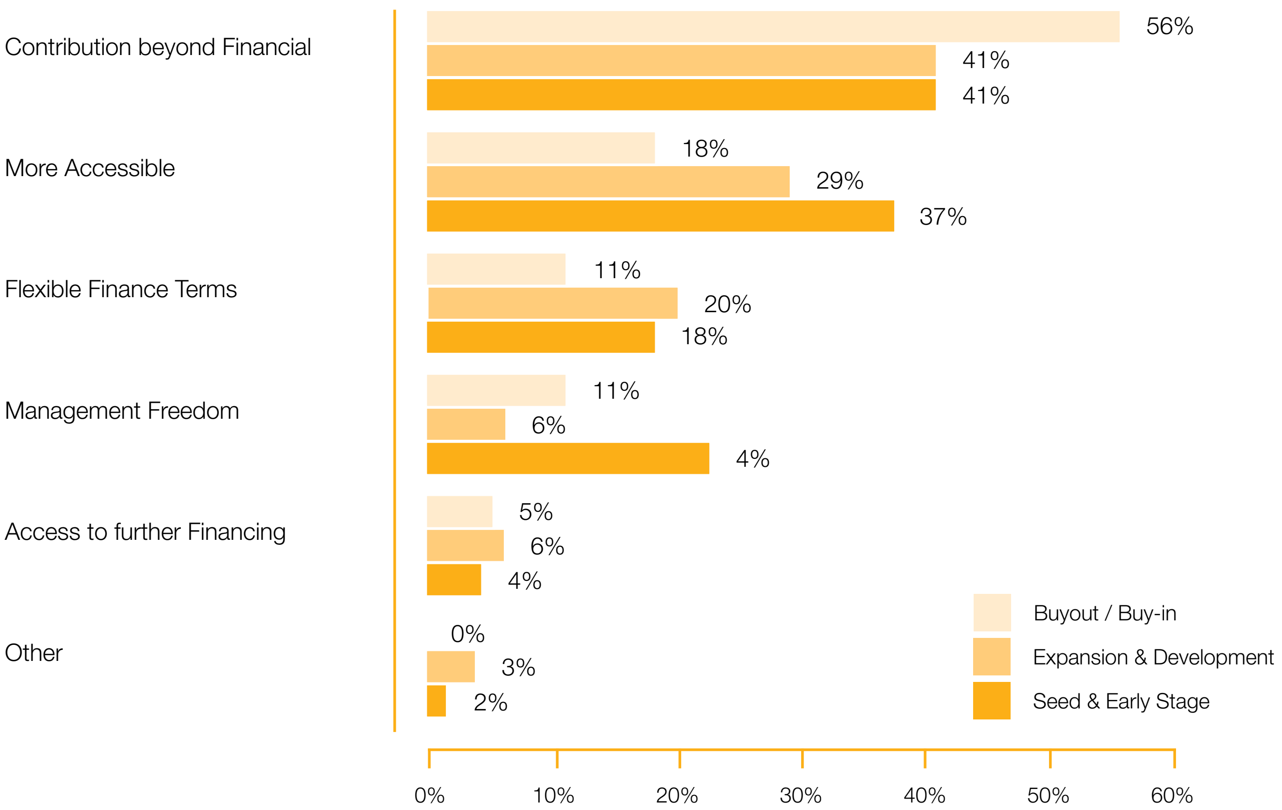



## Reasons for private equity preference

Respondents gave diverse reasons why they preferred private equity to other forms of equity financing. Almost half (46%) mentioned the positive contribution made beyond financing; this includes increased profitability and efficiency. For 28%, private equity was more accessible, whilst less stringent financing terms was named by 16% as the reason for their private equity preference.

> When analysing preference by financing stage, accessibility to financing is cited relatively more by seed and early stage capital recipients, which makes sense as these groups are at an early stage of their production life. Private equity groups were willing to take the risks involved and indeed were cited as better at understanding and managing these risks.

### Reasons for private equity preference - by financing stage



# Financial and employment performance

## Average growth rates

Respondents were asked to provide details of the financial performance and employment levels within their businesses for the years 2005/6 and 2008/9.

Private equity backed companies have shown steady growth in all areas. The main areas of growth within respondents' businesses were in exports, sales, EBITDA and capital expenditure, which showed modified average growth rates of 31%, 20%, 16% and 16% respectively.

Of the remaining variables measured, South African and worldwide employment and R&D expenditure all experienced positive modified average growth rates of 10%, 9% and 7% respectively[5].

### Average growth rates of private equity backed companies

| | Modified Average[6] | Sample[7] |
|---|---|---|
| Total Sales | 20% | 90 |
| EBITDA | 16% | 53 |
| SA Employment | 10% | 79 |
| Worldwide Employment | 9% | 37 |
| Exports | 31% | 23 |
| Capital Expenditure | 16% | 48 |
| R&D Expenditure | 7% | 22 |

When analysing growth by financing stage, the figures reveal some interesting trends:

- Buyouts show strong growth levels in almost all variables, including employment. Only capital expenditure shows negative growth of -5% although median growth over the period is 18%.
- Expansion and development capital businesses have shown similarly strong growth rates with a noteworthy 43% growth in exports.
- Seed and early stage backed companies have shown dramatic growth in most categories. Exports grew by 102%, more than doubling in each of the years in the period of consideration. EBITDA grew 32%, whilst capital expenditure and total sales grew by over 20% on average. Employment showed more modest growth with a 7% modified average growth rate whilst worldwide employment showed no growth at all.

## Comparison with listed companies

Private equity backed companies show a positive performance relative to listed businesses over the period of assessment. The growth in five key areas including sales, pre-tax profits, worldwide employment, investment and R&D were compared across private equity backed companies, all companies listed on the Johannesburg Stock Exchange (JSE) and the listed businesses that make up the ALSI 40 Index.

The growth rates achieved in sales, profit and employment by private equity backed businesses were ahead of those recorded for the public market.

It was only in investment growth that the public market out-performed private equity backed businesses.

### Comparison of growth rates – 2005/6 – 2008/9

| Modified Average | Private Equity Backed | Listed Companies - JSE | Listed Companies - ALSI 40 |
|---|---|---|---|
| Sales | 20% | 18% | 16% |
| Pre-tax profit/EBITDA | 16% | 14% | 15% |
| Worldwide Employment | 9% | 4% | 7% |
| Investment | 16% | 26% | 29% |
| R&D | 7% | 1% | 12% |

Source: SAVCA, IE Consulting and McGregor BFA


[5] The information contained in this section is based on available data.
[6] A modified average figure has been used which excludes the top and bottom 10 percentiles from the sample to remove the effect of outlying data points.
[7] Sample sizes vary where information has not been provided by the respondent.

# A note on the data collected for this report

The estimates of economic impact in this report are based on 327 responses to a questionnaire compiled by SAVCA, DBSA and IE Consulting. Respondents were, of course, not obliged to participate in this project and many chose not to provide responses to some of the more sensitive financial questions. Whilst the sample size is unprecedented in a survey of private equity backed firms in South Africa, drawing conclusions on the economic significance of the entire portfolio of private equity backed businesses is nonetheless very difficult. Care has been taken to consider the general make-up of the industry in South Africa when estimating portfolio values and IE Consulting, SAVCA and the DBSA feel that the figures derived from the model are representative of the true picture.

Within the sample population, only 1% of respondents had received funding prior to 1995, while the majority (68%) of respondents had received investment in the last five years. 2007-2009 is the peak period, representing 38% of the sample. In 86% of cases, the private equity investor still retains investments in the business and the sample therefore contains a degree of inherent bias towards more recent, un-exited investments. One might reasonably expect firms that failed, subsequent to a private equity investment, to take a dimmer view of the industry and, as interviews were only conducted with firms that were still in operation, it is fair to suggest that a small amount of survivor bias may exist in the report data.

Investments by private equity funds in the investees surveyed ranged from well below R1m to nearly R25bn. Investments of less than R2m were made in 24% of companies responding to that particular question; 30% of responding companies had received investments they classed as early stage capital; 61% of responding companies had received only one round of funding to date.

Where not otherwise expressed, the source for all data and charts in this report is the primary research conducted by IE Consulting amongst private equity backed businesses in South Africa on behalf of SAVCA and DBSA.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